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In the Matter of)
)
Price Cap Performance Reveiw) CC Docket No. 94-1
For Local Exchange Carriers)

REPLY COMMENTS OF SPRINT CORPORATION

Respectfully submitted,

SPRINT CORPORATION

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SUMMARY

Sprint Corporation consists of Sprint Communications Company, a large interexchange company, the Sprint LECs (the United and Central Telephone companies) operating in 19 states, and Sprint Cellular. Because of its dual role of being both a major access consumer and supplier, Sprint must view price cap regulation from internally conflicting perspectives and arrive at positions that fairly accommodate the legitimate interests of both access customers and suppliers.

Sprint believes that price cap regulation has produced benefits for both price cap LECs and customers. However, the plan can and should be revised to increase incentives to improve LEC productivity, foster infrastructure development, and enhance LEC competitiveness.

To improve LEC productivity and infrastructure investment Sprint recommends that the Commission remove LEC earning constraints. Further, the Commission should adopt a reasonable productivity factor. Sprint recognizes that removal of earnings limitations requires a quid pro quo for customers. In response, Sprint proposes continued use of the Commission's previous 2.8% productivity factor plus an additional 1.7% consumer productivity dividend, for a total annual productivity requirement of 4.5%. Further, Sprint recommends a 2% permanent price cap revenue reduction. Sprint believes these two actions are a realistic quid pro quo that benefit customers and justify removal of

earnings sharing obligations. As LEC earnings potential increases, incentives to invest in infrastructure improvements likewise increase.

LEC competitiveness should be fostered through the immediate implementation of density zone pricing for LEC access transport services. Needed deaveraging of transport will benefit both LECs and the customers while providing LECs the appropriate deaveraging tool they need to compete for the foreseeable future. To facilitate density zone pricing implementation, Sprint recommends that the proposed 2% permanent price cap revenue reduction be targeted to high and medium density zone transport prices. If a LEC does not believe it appropriate to apply the 2% reduction to density zone pricing, it should apply the 2% revenue reduction to equalize, and then further reduce, carrier common line charges. To further enhance competition, Sprint recommends that the annual 1.7% consumer productivity dividend reduction in the PCI be targeted to reduction in the Transport Interconnection rate element.

Sprint supports use of the Commission's original 2.8% baseline productivity factor (enhanced by a 2% permanent price cap revenue reduction and 1.7% annual consumer productivity dividend change to the PCI) and rejects both the USTA-proposed 1.7% Total Factor Productivity and 5.5%+ MCI, Ad Hoc, and AT&T factors. Sprint believes the 2.8% baseline factor developed by the Commission is reasonable and should not be changed.

The density zone pricing proposal by Sprint meets any competitive needs of LECs while protecting consumers against LEC access market power. Thus, Sprint opposes unlimited LEC pricing flexibility, removal of new services from price cap regulation and changes in tariff review procedures.

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REPLY COMMENTS OF SPRINT CORPORATION

Sprint Corporation ("Sprint"), on behalf of Sprint Communications Company, L.P. ("Sprint Communications") and the United and Central Telephone Companies ("the Sprint LECs"), hereby respectfully submits its reply comments on LEC price cap performance review pursuant to the Notice of Proposed Rulemaking ("NPRM") released February 16, 1994 (FCC 94-10).

Sprint is a local exchange carrier that serves nearly 6 million access lines in 19 geographically dispersed states; a global interexchange carrier for whom access is the single largest expense; and a major cellular service provider. Because of its dual role of being both an access provider and access customer, Sprint necessarily must weigh the issues in this proceeding from internally conflicting perspectives and must therefore, in a very real sense, endeavor to arrive at positions that fairly accommodate the legitimate interests of both access customers and access providers.

In the NPRM, the Commission requested comment on whether the LEC price cap plan could "be revised to better serve the goals of the Communications Act and the public interest in the years ahead." Sprint believes that LEC price cap regulation has generated substantial public benefits but that those benefits can and should be increased through adjustments to the LEC price cap plan. Any changes should be aimed at increasing incentives to improve LEC productivity and foster infrastructure development. Additional changes to density zone pricing would provide appropriate competitive pricing flexibility for LECs while recognizing their market power in the access market. Within the density zone framework, targeted, non-discriminatory rate reductions could greatly assist LECs in more closely aligning access prices with underlying costs.

There is a wide divergence of opinion in the initial comments concerning the appropriate going-forward productivity factor that should be applied to LECs. Establishing a productivity factor that is too high would have a very negative impact upon price cap incentives; establishing a productivity factor that is too low provides little challenge to the price cap carriers and would likely result in excessive rates. Thus, care must be taken so that the current positive reaction to price cap regulation is not destroyed through establishment of an unrealistic factor. In Sprint's view, the 1.7% historical productivity factor proposed by USTA and the BOCs is unrealistically low while the 5.5%+ factors proposed by MCI, AT&T and Ad Hoc are unattainably high for any extended period of time.

It is clear that LECs retain market power in the access market, that CAPs and other access competitors have a very small national access market share, and that as a result, continued regulation of LEC access pricing, including some level of pricing control beyond "pure price caps," is appropriate within the baskets so that services using common inputs do not have unreasonable pricing relationships. It is particularly important that a reasonable pricing relationship between tandem transport, DS1 and DS3 switched transport service be maintained so that all carriers using common facilities share equally in the LEC economies of scale. In Sprint's view, amending density zone pricing would, under present conditions, provide LECs with sufficient pricing flexibility and would obviate the need to remove basket subindices and to allow special customer-specific pricing plans.

I. THE PRODUCTIVITY FACTOR MUST BE REASONABLE FOR THE NEXT PRICE CAP PERIOD

A. If Earnings Sharing Is Removed, Sprint Supports A Productivity Factor Of 4.5% For The Next Price Cap Period And A 2% Permanent Price Cap Revenue Reduction

Sprint supports the use of the Commission's original 2.8% baseline productivity factor produced from averaging the results of the Spavins-Lande and Frentrup-Uretsky studies.[1] As discussed below, Sprint rejects both the USTA-proposed 1.7% Total Factor Productivity ("TFP") and the 5.5%+ factors proposed by MCI, AT&T, and Ad Hoc. However, if the Commission adopts the

[1] Policies and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd. 6786 (1990) (Price Cap Order).

proposal by Sprint and others to remove earnings limitations (i.e., elimination of sharing), some form of quid pro quo should be provided to customers in exchange for the LECs' increased earnings potential. Sprint also believes that the elimination of sharing justifies continued application of a consumer productivity dividend during the next price cap period.

Sprint proposes that this new consumer productivity dividend consist of two elements. First, Sprint proposes a 2% permanent reduction in interstate price cap revenues (flowed through to appropriate price cap index values) targeted to high and medium density zone transport rates[2] and second, a 1.7% consumer productivity dividend targeted to reductions in the Transport Interconnection rate element. In the event that a LEC does not believe it appropriate to use any or all of the available 2% revenue reduction for density zone pricing restructure, then it should target the remainder of the 2% reduction in revenue to first equalizing the originating and terminating carrier common line rates and then reducing those rates. These two actions, when combined with the 2.8% baseline productivity factor, produce immediate, sizable and permanent benefits to the public through the price cap index adjustment and additional continuing benefits over the price cap period by requiring LECs to generate annual

[2] LECs should supply incremental cost support that will provide a basis for a price floor beyond which LECs may not reduce their transport density zone prices.

productivity improvements of 1.7% in excess of historical averages established in the Price Cap Order.

In operation the Sprint proposal would appear thus:

Price Cap Period 2, Year 1	2% Permanent Price Reduction
Price Cap Period 2, Annual Productivity Factor	2.8%
Consumer Dividend	1.7%
Total Annual Productivity Requirement[3]	4.5%

Sprint believes that a refined price cap plan can be constructed utilizing these productivity factors to provide even more benefits to consumers and price cap companies. To recognize these additional benefits, Sprint proposes that the suggested permanent rate reduction, equivalent to 2% of total price cap revenues, be targeted to high and medium density zone transport rates. This would speed needed deaveraging. As Sprint discussed in its Comments[4] , this action would require adoption of density

[3] If the Commission adopts a per line common line cap and deletes the 50/50 sharing of common line growth from the plan, an .8% reduction in the productivity adjustment should be made. *See* AT&T at 26. Thus, the 4.5% Total Annual Productivity Requirement would be reduced by .8% to 3.7% to reflect that change.

[4] Sprint at 8-11. Sprint has consistently supported density zone pricing as an appropriate cost-based response to competition in the access transport market. Sprint believes that more complete implementation of density zone pricing is necessary to provide the correct economic signals to customers and new entrants into the transport market. Sprint has further argued for an expansion of zone pricing flexibility once density zone pricing is implemented. The current rules permitting +5%/-10% constraints for zones do not provide LECs sufficient opportunity to realign their transport rates with costs in a timely manner. However, Sprint also recognizes the Commission's concerns with the impact of full and immediate deaveraging on transport rates in low density zones. Targeting the 2% permanent rate cut to high and medium density zones provides needed deaveraging while protecting low density zones from rate shock.

zone pricing irrespective of the existence of actual collocation in a study area.

This recommendation will provide widespread benefits to consumers, IXCs, and the price cap LECs. Price cap LECs will realize the significant and immediate competitive benefits of density zone pricing. Consumers generally will benefit from reductions in toll rates made possible by the reduction in access rates. Sprint estimates that the additional benefit of the 2% permanent rate reduction for all price cap companies would be approximately $456 million[5] each year. At the same time, transport rates in the low density zone would, in the worst case, remain unaffected by this action, thereby allaying any concern as to any negative impact of deaveraging on rural areas.

In addition to the 2% up-front permanent rate reduction, Sprint also suggests that the Commission adopt a consumer productivity dividend of 1.7%, bringing the total annual productivity offset to 4.5%. However, rather than applying the new consumer productivity dividend to all access baskets, Sprint proposes that the dollar value of the 1.7% consumer productivity dividend, computed on the basis of all price cap revenues, be targeted to reductions in the Transport Interconnection rate element.

The benefits of this proposal are several. First, IXCs will realize additional substantial reductions in their access bills

[5] This calculation is based on Price Cap Carrier composite data from the 1994 annual filings--Bellcore TRP analysis R(r-1) = $22,792,211,147 x .02 = $455,844,223.

as a result of the 1.7% consumer productivity dividend. Consumers will correspondingly benefit from the reduction in interexchange rates made possible by the reduction in access charges. Sprint estimates that the benefit of the 1.7% consumer productivity dividend to be, for all price cap companies, some $387 million per year based on current price cap revenues.

The proposal would alleviate both the Commission's and competitor's concerns with the Interconnection rate element by phasing it down[6] and will facilitate competition in the transport market. Reducing or eliminating the Interconnection element also serves the long term interests of the price cap LECs by enhancing their competitive position in the marketplace. Under the current rules, competitors in the switched transport market are required to pay the Interconnection rate on each switched minute. In the long run, however, the Interconnection rate provides an artificial or uneconomic incentive for competitors and customers to avoid using the LEC's switching functionality.

An essential component of the Sprint proposal is the elimination of sharing, discussed infra at II A and B. The 2% permanent reduction in the price cap index ("PCI") and the increase in the productivity offset to 4.5% alone warrant the quid pro quo of eliminating sharing.

[6] Any LEC that completely eliminates the Interconnection Rate element through these actions should re-target the 1.7% consumer productivity dividend to general access rates.

Sprint's proposal represents a reasonable and realistic balancing of interests between LECs and their customers. LECs would receive relief from earnings sharing, price cap productivity and investment incentives would be maximized, and customers would benefit from both a permanent 2% reduction in price cap revenue and a higher level of required annual productivity achievement.

B. The Base Productivity Factor Proposed By USTA And The BOCs Is Unreasonably Low And Will Provide LECs With Windfall Benefits

In its comments, USTA presents an analysis which purports to justify a productivity factor of 1.7%.[7] This factor was based on a TFP study for the period 1984-92 for price cap LECs. USTA warns that "as access markets become increasingly competitive, it will become correspondingly more difficult for LECs to achieve a given level of productivity . . . because . . . the LECs' ability to benefit from economies of density diminishes."[8] USTA and the BOCs further oppose adding an explicit consumer productivity dividend.[9]

The Commission has already considered and declined to adopt the methodology underlyng USTA's 1.7% factor. In the Price Cap Order, the Commission decided to base the LEC productivity offset

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7 USTA, pp. 79-84 and Attachment 6, "Productivity of the Local Telephone Operating Companies," by L. Christensen, P. Schoech and M. Meitzen. This productivity factor is generally endorsed by the BOCs and GTE. Ameritech at 11 (implicit support of 2.8%), Bell Atlantic at 15 (no higher than 1.7%), Bell South at 9, 34 (1.7%), GTE at 73-75 (lower based on 1.7% TFP and 2% cable), NYNEX at 41 (no higher than 1.7%), Pacific Bell at 31-34 (recommends 0 productivity factor but cites 1.7% TFP study), Southwestern Bell at 34 (reduce from current with cites to 1.7% TFP study and 2% cable), and US West at 15-16 (current factor is acceptable).

8 Id. at 82-83.

9 Id. at 84.

on internal staff studies (the Frentrup-Uretsky and Spavins-Lande analyses), noting that its internal studies were superior to those submitted by various commenting parties in many respects. For example, the Frentrup-Uretsky productivity analysis "adjusts for exogenous effects of both cost and demand changes. . . [and] focuses directly on interstate switched access prices and demand,"[10] while the Spavins-Lande study "provides more stable results, less subject to economic variations and short term events . . . and includes effects of special access."[11] In contrast, the USTA TFP study considers all LEC services--local service, intrastate access, long distance services (both inter- and intrastate), miscellaneous services as well as interstate access--and apparently did not make the kind of exogenous cost and demand adjustments which the Frentrup-Uretsky model incorporated.[12] Compared to the Commission's productivity analyses, the USTA study is overly broad in terms of the services included, fails to make numerous exogenous adjustments, and is not balanced by long-term considerations. There is no reason to believe that use of the TFP study presented here by USTA is a more reasonable measure of LEC interstate access productivity than the Commission's own pro-

[10] Id. at ¶97.
[11] Id. at ¶98.
[12] For example, the Frentrup-Uretsky analysis removed USF, equal access conversion, inside wire, and CPE costs; adjusted revenues for the type of exogenous changes reflected in the price cap calculations (e.g., transition to SPF, implementation of reserve deficiency amortizations, revised separations calculations for DEM, Account 645 and COE Category 4 terminations, etc.); and adjusted demand for the effect of stimulation associated with implementation of subscriber line charges (id., Appendix C, ¶¶5-6).

ductivity analyses. This conclusion is as valid now as it was when the Price Cap Order was adopted.

The flaws in the USTA TFP study result in a productivity factor which is unreasonably low. As the Commission has repeatedly emphasized, the productivity factor used must balance the interests of ratepayers and LEC shareholders, and foster a more efficient telephone industry.[13] Implementing a productivity offset which is too low, as USTA and the BOCs recommend, would eviscerate the benefits of price cap regulation by preventing consumers from being better off under price cap regulation and by providing insufficient cost-cutting incentives for the LECs. Elimination of the consumer productivity dividend would only exacerbate the problem by reducing LEC incentives to generate productivity gains in excess of historical experience.

USTA's complaint that an increase in competition will adversely affect LEC productivity gains is similarly unpersuasive. This argument completely ignores the fact that competition is a spur to increased productivity. It may be true that a decrease in LEC output growth might result in lower productivity gains (that is, that some economies of density are present), assuming no change in input costs. However, competition also should stimulate LEC efforts to reduce costs at a rate greater than the reduction in demand/decrease in output. In any event, as discussed in Section III.A below, any access or local service compe-

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[13] *See, e.g.*, Policies and Rules Concerning Rates for Dominant Carriers, 3 FCC Rcd 3195, 3406 (¶381) (1988) ("FNPRM") at ¶384 and Price Cap Order ¶75.

tition which the LECs may face today and in the foreseeable future is minimal. Thus, any decrease in output due to competitive losses is also likely to be minimal. All other things being equal, continued use of currently effective productivity factors for the upcoming monitoring period should not constitute an unreasonable burden on price cap LECs.

C. The Productivity Factors Proposed By MCI, AT&T And Ad Hoc Are Unrealistically High And Will Dampen Price Cap Incentives And Performance

A few parties suggest that the price cap productivity requirement be increased from the current 3.3% factor to 5.5% or higher.[14] MCI argues that the original requirement of 3.3%, consisting of 2.8% historical productivity plus .5% consumer productivity dividend, was set too low.[15] AT&T indicates that the LECs actually achieved productivity increases (assuming an 11.25% return) on average, of 5.97% during the first price cap regulation period.[16] The fact that LECs have earned well under price cap regulation neither requires an apology nor is it cause to expect that future productivity levels will equal those of the initial period. To the contrary, LECs achieved present productivity levels through tough management controls which focused on removing cost from their business in response to a price cap plan that re-

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14 MCI at 26 (5.9%), AT&T at 22 (5.47%), Ad Hoc at 21 (5.8%), WilTel at 8, and ICA at 12.
15 MCI at 26.
16 AT&T at 23.

warded LECs for exactly that action. Sprint believes this rate of cost containment cannot be sustained over the long run.[17]

Because of these claims that the productivity factor was initially set too low and simply because the achieved productivity has been higher than the initial required productivity factor during the first price cap period, these parties believe that an unrealistically high productivity requirement should be established for the future price cap period. In contrast to the BOCs and USTA, these parties have an incentive to maximize the LECs' required productivity factor in order to reduce their single largest expense, access.

MCI has not produced a new productivity study in support of its position. Rather, MCI argues that the Commission erred in its initial determination of required productivity by including all data points in the original Spavins-Lande long term productivity study, which calculated a 2.25% average annual productivity improvement, and in the Frentrup-Uretsky short term study, which calculated an average annual productivity improvement of 3.43%. (These were averaged to 2.8% and a consumer dividend of .5% was added.) MCI proposes to remove one data point from the short term study, ignore the long term study, and use only selected data from the short term study to produce a proposed productivity factor of 5.4% plus a consumer productivity dividend of .5% for a total required productivity of 5.9%.

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[17] Sprint at 3 and 11.

Ad Hoc's study is also flawed. It included only seven states and added a "stretch" to produce its 5.8% factor. The limited sample included in the ETI analysis varied widely and in Sprint's view does not substitute for the more thorough analysis previously performed by Spavins-Lande and Frentrup-Uretsky.

AT&T's recommendation of a 5.47% productivity factor (5.97%-.5% LEC productivity dividend) is based on its calculation that LECs achieved average productivity gains of 5.97% during the initial price cap period (assuming an earnings level of 11.25%). Assuming that LECs will continue to be allowed to earn 11.25%, AT&T claims that continuation of the 5.97% achieved productivity over the short run under price cap regulation is reasonable.

Price cap regulation can provide LECs with enhanced productivity and investment incentives through removal of earnings restraints. AT&T would have the Commission take much of the LECs' benefits from past productivity gains achieved under price cap regulation, and create a plan where additional LEC earnings would be very difficult to achieve, thus chilling the incentives price cap regulation was designed to foster.

Sprint believes the Commission was correct in using an average of the short and long term studies and all data points in its initial baseline productivity requirement of 2.8%. Further, Sprint does not believe that the required productivity factor, without other adjustments, should be at the unreasonably high level of 5.5%+. While actual performance by price cap LECs over the price cap period indicates that the achieved productivity was 5.97% (to yield 11.25% return), Sprint's comments indicate that future productivity gains will be harder to come by. Because future productivity gains may well not meet those of the recent past, it is inappropriate to base future benchmarks on the results of only the past three years.

The 5.97% productivity factor achieved for the first price cap period highlights the success of price cap regulation as a valuable tool to induce carriers to implement productivity-enhancing actions. The price cap LECs harvested the "low hanging fruit," the most apparent and available productivity enhancing activities, and exceeded the 3.3% target productivity factor. However, much of the "low hanging fruit" is gone and harder, more risky actions must be taken in order to continue to improve productivity. Sprint does not expect that the 5.97% productivity rate will continue ad infinitum or that it is appropriate for the next price cap period. Other things being equal, Sprint believes retention of the Commission's original 2.8% productivity factor is appropriate.

D. The Productivity Factor Must Include Offsets For Any Additional Revenue Affecting Changes

Sprint did not oppose the suggestion that the 50/50 common line sharing mechanism be replaced with a per line common line cap.[18] However, Sprint pointed out that any changes that affect

[18] Sprint at 15.

revenue or the LECs' overall productivity requirement must be netted against the underlying productivity factor.

In its comments AT&T quantified the net change in the productivity factor associated with removal of 50/50 sharing of common line growth at .8%.[19] Sprint accepts this analysis. If the Commission discontinues 50/50 sharing of common line growth, then the appropriate offset to the base productivity factor would be .8% as quantified by AT&T. Sprint asserts that this offset must be made in order to appropriately recognize the increased LEC productivity requirement associated with this change.

Further, some parties suggest that a one-time reduction in LEC prices occur. MCI recommends a 7.5% reduction, ICA a 3% reduction, and AT&T an unquantified reduction.[20] The alleged justifications for this proposed reduction in LEC rates include MCI's claim that the original productivity factor was set too low and AT&T's suggestion that the alleged change in cost of capital should result in a reduction in prices.[21]

Sprint asserts that the initial productivity factor of 3.3% was not too low for the initial price cap period, as discussed above. Further, as discussed infra at II.C., Sprint believes the cost of capital has not shown any persistent change and that no adjustment for changes in capital costs is appropriate. Thus, Sprint does not believe that either of these claims justifies a

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[19] AT&T at 26.
[20] MCI at 26, AT&T at 30, and ICA at 2.
[21] MCI at 26 and AT&T at 30.

one-time reduction in LEC rates. LECs worked hard improving their productivity so that they could reap the rewards of price cap regulation. A one-time reduction in LEC rates based on either the flawed MCI or AT&T argument appropriates the rewards of exceeding the price cap productivity standard.[22] LECs will not continue to be motivated to improve productivity if any potential benefits are consistently taken by "one-time" price decreases that penalize a LEC for outperforming the average of the industry. Because LECs have a finite amount of productivity enhancing opportunities, they will simply not attempt to outperform the established productivity goals because they will have been shown that their efforts will shortly result in those potential rewards being appropriated. Early outperformance of the industry average by withdrawals from their total available productivity opportunities will result in later underperformance because further productivity opportunities are not available and prior benefits have already been taken from the LEC.

II. PRICE CAP PRODUCTIVITY INCENTIVES MUST BE MAXIMIZED

A. Removal Of Earnings Restrictions Maximizes LEC Productivity And Investment Incentives

Sprint recommends that earnings sharing and the lower formula adjustment mechanism be eliminated. Once prices are capped,

[22] The MCI and AT&T basis for a one-time price reduction is flawed because it confiscates past productivity increases. In contrast, Sprint proposes a 2% permanent price cap revenue decrease as part of the quid pro quo to access customers for future removal of sharing obligations. Sprint's proposed adjustment is a trade while AT&T's and MCI's are confiscatory.

all risks and earnings from services should be retained by the service provider. Sprint believes that the investment and productivity incentives that full earnings retention promote must be fostered, and that failure to modify the LEC price cap plan to allow LECs to retain the profits from their operations will weaken many of the incentives that LECs would otherwise have to reduce costs, improve efficiency and invest in telecommunications infrastructure.

Sprint and many other commenting parties[23] demonstrated that full earnings retention under price cap regulation is necessary if the benefits of price cap regulation are to be maximized. Nonetheless, certain commenting parties advocate continuing the sharing mechanism.[24] Their recommendation ignores the fact that productivity and investment incentives are not maximized under price cap regulation unless LECs are allowed to retain all earnings. As long as LECs have an incentive to invest in businesses other than their regulated LEC operations because of "greater 'reward' in unregulated service investments," infrastructure investment is at risk.[25] Further, many of the productivity actions that LECs might take in the future are difficult to implement, require resources that could be directed elsewhere, and bring added business risk to the enterprise. These changes will not be

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[23] *See, e.g.*, Sprint at 5-6 and 13-15, Pacific Bell at 43-44, US West at 10-12, USTA at 45-52 and CCIA at 7-8.

[24] *See, e.g.*, AT&T at 29-30, MCI at 27, and California Cable Television Association ("CCTA") at 5.

[25] *See*, CCIA at 8.

implemented unless the perceived reward exceeds the effort expended and the risk assumed. If much of the expected reward for these productivity enhancing activities is taken from the LEC, the incentive to undertake these actions is severely diluted. Thus, in order to maximize investment and productivity incentives for the LEC, earnings sharing must be eliminated.

B. Removal Of Earnings Sharing Reduces The Risk That LECs Might Implement Anti-Competitive Cross-Subsidization

Some commenting parties asserted that LECs have an incentive to anti-competitively cross-subsidize more competitive products from revenues obtained from less competitive services.[26] However, to the extent that a LEC might have such an incentive, removal of rate of return restrictions and earnings sharing obligations, unneeded vestiges of rate of return regulation, blunt that incentive.

In analyzing the potential for anti-competitive cross-subsidization in the long distance market, Sprint Communications has long argued that the potential for anti-competitive cross-subsidization exists in multiproduct markets where there is dominant firm price leadership, ineffective competition in some market segments, and high fixed costs.[27] With these conditions, that exist in the access market, it is possible to engage in anti-competitive overhead and fixed cost recovery without ever

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[26] *See, e.g.* MFS at 35-36.

[27] *See*, M. Sievers and B. Albery, *Strategic Allocation of Overhead: The Application of Traditional Predation Tests to Multiproduct Firms*, 60 Antitrust L.J. 757 (1992).

pricing below marginal costs and without ever realizing a reduction in revenues or profits. Focusing on limiting the level of the dominant price leader's earnings does nothing to detect or prevent anti-competitive or strategic repricing between more competitive and less competitive market segments in such markets.

When a LEC can retain all of its earnings, its incentive to price one service below cost and subsidize that service with revenues from another service is diluted because this would generally result in lower total firm earnings and would suboptimize the total earnings potential. However, a business that would be giving revenue back to customers because of earnings restrictions and sharing obligations might be tempted to undertake such action because it could not keep the revenue used in the cross-subsidy transaction even if it did not cross-subsidize. Thus, earnings sharing and an earnings cap facilitate true cross-subsidy opportunities which price cap regulation, without such sharing and earnings restrictions, discourage.

Sprint believes that the most effective means of limiting anti-competitive cross-subsidization and strategic allocation of overheads and fixed costs is simply to limit firms' ability to raise prices in less competitive market segments to supra-competitive levels. To prevent anti-competitive cross-subsidization, it is critical to focus on prices, not earnings.